UNITED STATES DEPARTMENT OF COMMERCE

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EMERGENCY OIL AND GAS GUARANTEE LOAN BOARD

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PUBLIC MEETING

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WEDNESDAY

SEPTEMBER 22, 1999

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The Board met in the Auditorium in the Herbert C. Hoover Building, 14th Street and Constitution Avenue, N.W., Washington, D.C., at 1:30 a.m., Jon Orszag, Assistant to the Secretary and Director of the Office of Policy and Strategic Planning, Department of Commerce, presiding.

PRESENT:

JOHN ORSZAG, U.S. Department of Commerce

JOHN LOPEZ, Federal Reserve

DON WINN, Federal Reserve

SUSAN WYDERKO, Securities and Exchange Commission

C-O-N-T-E-N-T-S

P-R-O-C-E-E-D-I-N-G-S

(1:35 p.m.)

MR. ORSZAG: Welcome. To those of you who were here this morning, we said a little about just how we were setting this up, and so I'll repeat it just because some of you probably weren't here, because this is now dealing with oil and gas.

The purpose of this is to listen. It's to get the input from the public on the operation of the two programs -- Steel Loan Guarantee we looked at this morning, and oil and gas this afternoon. So, we will not be asking questions except to that extent that we need clarification on a point, a point that we think we'd like you to elaborate on so we understand what you were trying to get at.

With that, I think -- I'm John Orszag. I'm the Director of Policy here at the Commerce Department. I'm joined up here by Don Winn from the Federal Reserve and Susan Wyderko from the Securities & Exchange Commission. As you know, the Commerce Department, the Fed, and the FTC make up the -- all three of our bosses make up the Board of the Oil and Gas Program, and so we're representing our bosses to listen to the comments from the public.

I think Don wanted to just say something here right at the beginning, because I think he has to leave early.

MR. WINN: I also would like to welcome the witnesses here today, and we're very much looking forward to your presentations. We'll be listening attentively, and we have a challenge to carry out the intent of this legislation, and we're looking for your help in moving ahead as to the best way which we can make this the most effective program possible. And we'll be looking forward to your testimony.

With that, I'd like to ask Mark Murphy to start off. He's the President of Strata Production Company -- yes, that would be great, so everyone can hear you.

MR. MURPHY: Good afternoon. My name is Mark Murphy. I'm President of Strata Production Company. My company is a small, independent oil and gas producer based in Roswell, New Mexico. I'd say we're somewhat of a typical independent. We have ten full-time employees. All of our production is in operations or in southeastern New Mexico and west Texas, so we do have a very focused geographic -- geographic focus.

I have prepared written comments, and I believe those either have or will be given to you, and so I'll defer to those on the details, because I'm not going to try to read all of this verbatim but hit most of the high points.

I'm here today to testify on behalf of the Independent Petroleum Association of America and the National Stripper Well Association, and in Washington lots of acronyms are used, so I guess I'll start off by saying that's IPAA and NWSA. But the Stripper Well Association and the IPAA appreciates the opportunity to be here today.

IPAA represents the interests of about 7,000 independents. We produce 40 percent of the domestic crude oil, 66 percent of the domestic natural gas, and you would think of us, I guess, as the wild cat'ers -- we drill 85 percent of all the exploratory wells. We would maintain that we're the true strategic petroleum reserve, because we operate the stripper wells that account for roughly 1.4 million barrels a day or about the same amount as we import from Saudi Arabia.

So, we view this Program very seriously. We appreciate the opportunity to comment on it. I wish to begin by thanking Secretary Daley and the representatives of the Board here today. I'd also like to thank Senator Domenici who we worked closely with in the authorship of this legislation, and Senator Byrd for his assistance, and all those in the House of Representatives that were helpful in getting this through.

During the last 18 months, America's oil and gas producers and the small service companies have been devastated by low crude oil prices. Estimates range between 50 and 70,000 jobs have been lost, and in any industry, this would be considered a catastrophe, and it is here as well.

We've seen a lot of businesses close, and we've seen a rippling effect through the economies, and I really want to stress that, because this Program will not only help individual companies, but it will help entire towns and regions. When my company quits drilling, it affects a lot of other people, everywhere from the local drug store to the corner gas station, and these businesses have been affected as well.

Some people will say, "Well, prices are back up. Isn't everything rosy again?" And the answer to that is no. We've had over 18 months of low prices. We've seen about six or eight weeks of a price recovery. We don't know how long that's going to last. Our cash reserves are depleted. We have not seen any sort of corresponding development activity occur, and I think people are hopeful that prices will stay up at a reasonable level, but we certainly can't count on that.

We believe that a well-structured loan program for these small businesses could facilitate a recovery, not only to help our companies but the communities that we live in, as well, and we've seen examples in the automobile and agricultural and other industries where similar programs really saved an industry, and I think that's the opportunity that we're presented with here today.

Both IPAA and the National Stripper Well Association believe that the Program should be based upon sound business and lending practices. These practices exist today; however, due to the nature of the emergency, certain adjustments are needed, and these fall into really three broad categories. Those are loan processing and required documentation, loan-to-value ratio and amortization term, and interest rates.

First off, for this Program to be effective it needs to be implemented quickly, and people need to be able to take advantage of it. In traditional oil and gas loans, we've seen those approved in 30 to 45 days. We would hope that this -- the process that's ultimately developed here would not take longer than 60; at most, maybe 90 days. And this ought to be ample time for the lending institution to go through its process and for the managing agency here in Washington, or wherever that may fall, to go through its due diligence process as well.

Traditionally, there's two fundamental pieces to an oil and gas loan: one is the reserve report, and the second is the financial statements. Now, there's a couple of unique things about the oil and gas business, especially small independents. With respect to reserve reports, there's certain reserve classifications, and I'm sure the representative from the Securities & Exchange Commission is very familiar with these.

Proved developed producing -- that's best thought of as reserves that are actually being produced from the existing well. There are proved developed non-producing or what we in the industry call behind pipe reserves. These are reserves that are known to produce but have not been developed in that particular well bore yet. And there's proved undeveloped reserves, and those are traditionally thought of as offset locations. In other words, an area immediately adjacent to a producing well that has a high degree of certainty of producing as well.

These are classified under standards set by the Society of Petroleum Engineers, SPE, and, as I say, they're well recognized in the industry, and they're well recognized by Government agencies and others. We believe that the reserve reports that are prepared for this Program should be no different than the sorts of reserve reports that have gone into traditional lending structures. These are generally prepared by registered professionals or petroleum engineers along with the assistance of geologists and other specialists. And these individuals are available to any company throughout -- whether you're talking about Kentucky or southeastern New Mexico, there's professional engineers that are available to assist.

Generally, relationships already exist. I have a relationship with a petroleum engineer that knows my properties inside and out. He's provided -- it's an arm's length relationship. He's provided reports to banks and other people, and he should be -- those sorts of professionals should be allowed to continue to do that.

And the reason I draw this distinction is, is that it's not necessary to have a registered professional or petroleum engineer on staff of a lending institution. There are those individuals that are out there that can do these sorts of things at a very time-effective and cost-effective method, and that should continue to be allowed.

And, in addition, there's also relationships with accounting firms, certified public accountants that do this same sort of thing for small companies. Typically, these financial statements are either compiled or reviewed; very seldom are they audited. And my point is, is that the reserve reports and the CPA financial statements or the internally generated financial statements or whatever is acceptable to a lending institution, those sorts of things ought to be kept the same. In other words, there shouldn't be any more stringent requirements than that, because that's simply going to slow down the process, and it's not going to be practical for a lot of small companies.

I've gone in quite a bit in my written testimony about loan-to-value ratios and amortization terms. I'll touch on that quickly. And that is, is that in the past we have seen where a loan amount is based on roughly 50 percent of the proved developed producing reserves, the PDP reserves, as I described earlier. And that, I believe, needs to be expanded.

In other words, if you go out and sell a property -- if my company was to sell a property to another company, typically the sales price would recognize anywhere from 90 to a 100 percent of that PDP category. And, so under a traditional loan structure, we lose a lot of value for that.

And what I'm suggesting to you is that just as the marketplace recognizes higher value for various classifications of reserves, so should the Program, because that is going to provide additional loan-to-value ratios that are needed right now. These other types of reserves of PDNP, behind pipe, and proved undeveloped reserves should also be recognized as well.

And I have proposed, after a lot of

discussion with my peers and various folks, a formula in my written comments, which I'll just refer you to instead of trying to go through it at this point.

Probably another very critical aspect is in the reserve reports, we typically see a present value calculation and the best way to think about that is that oil and gas wells generate a stream of oil and gas, and therefore that's converted into cash based upon the price. But that comes in over a period of time, and that's known as the reserve life. Some areas have very long reserves lives; some formations have shorter reserves lives.

But the higher the discount factor, the present value factor, the less those future dollars are worth today. That typically has been set at roughly ten percent, because in the past many times that was the cost of money, essentially. I mean, when you looked at what the interest rates were -- and it also provided, I think, some risk protection for some of the lending institutions.

Those numbers have now come down to around nine, in some cases eight percent, in the commercial market. I'd suggest to you that PV calculation, present value calculations, ought to reflect more closely upon what the inflation value is or certainly no more what the interest rate under the Program is, something in the five to seven percent.

We did a rough calculation this morning, and what that means is that for every percent -- or what we found was is that for every percent that you drop the present value percentage, you gain about three percent in terms of present value. So, in other words, if you go from a PV ten number, present value discounted at ten percent, to a present value discounted at five percent, you get about 15 percent more value in that future income stream discounted in today's dollars, and that's significant.

Just as the loan-to-value ratios are important, the amortization term is also important, and we have also suggested that a formula for that that would mirror what I just talked about in terms of the loan-to-value ration, giving a fairly high 75 to 85 percent value of PDP reserves, roughly 50 percent of behind pipe reserves, and 25 percent of undeveloped reserves. And the reason for the percentages is to account for the risk of each of these reserve categories even though they're proven, and hopefully that is clearer in my testimony than what I just stated.

We also would say that over the next couple of years under a well structured Program, if these sorts of considerations are made, it will inject capital into a company and into the industry, and that has a number of very positive effects. One is the capital that is in excess of the existing loan amounts will be put into developing the non-developed reserves, the PDNP and PUDs.

That does a couple of things. One is it enhances the collateral value, the ultimate collateral value that you all will be looking at. And, two, it also send an amount of money into the local and regional economies. In other words, for me to go out and develop those reserves, I have to hire someone to do a lot of that work, and that means that the service sector, which this Program is also targeted for, will benefit from that just as the professional engineers and the accountants and everywhere else. What I want to stress is this is not just an individual company's Program. Certainly it has those benefits, but it has a rippling effect through economies all over our nation.

The interest rate is a very, very

important point. Typically, we've seen -- I think one of my colleagues will be going into this in a little more detail -- but we've seen interest rates in the range commercially of prime or plus two or three percent. I believe the interest rate that's being considered is something along -- at least initially to start with is a T-bill rate or something having to do with the maturities of outstanding obligations. And we are also -- from what I understand, there are certain programs that have a cap on that, and we would suggest that you look to those programs, the SBA programs and some of the other loan guarantee programs, and pull out the best elements of those programs.

And one of those is a cap above the cost of money to the lending institution. Amortization term and interest can make a huge difference. If you amortize a loan at a five-year basis at ten percent versus ten-year basis at seven percent, you're going to cut your principal and interest payments by about 40 percent, and that's the additional cash flow that the industry needs.

A couple final points that ought to be considered. Some of these are that -- a sale of individual property. In other words, my company has a number of properties that we operate. We may have the opportunity to sell that property to another company, and when we have that opportunity we ought to be able to do that.

In other words, there ought to be a partial release of the mortgage that secures that individual property and at the same time the funds that I receive for that property ought to pay down the principal so there's a corresponding benefit. In other words, the amount that would be guaranteed under the Program would be paid down in exchange for the release of the property. The bottom line is that sort -- those sorts of normal transaction should not affect the underlying guarantee of the individual loan.

Last point is many regional and local and regional banks are interested in participating in this Program. There's probably three or four or five top energy lenders in the country. But the Program presents an opportunity for some of these smaller banks to begin participating, and I would really encourage you to look at incentives to encourage these smaller local banks.

Two-fold effect: One is, in many cases

what you'll find is where a producer or a group of producers reside, where the oil fields are, many times you see a flight of capital out of these areas to energy lending centers. That may be Denver, it may be Houston, it may whatever. But places like Roswell, New Mexico and Hobbs, New Mexico, and Farmington, New Mexico, and Midland, Texas, and a whole lot of other places can benefit from keeping that capital local in a local institution.

These smaller banks traditionally have not gotten involved in energy lending, but I think that under this program, from everything I've heard, they would like to get involved, and I think long-term that's a very good thing. It provides a larger and more diversified group of energy lenders, and it also allows them to gain some experience with energy lending where that as this Program expires over the next several years, they could then begin looking at doing traditional loans because of the experience that they've gained here.

We believe that a well constructed program has the potential for allowing for a significant portion of the domestic petroleum industry to recover from the last 18 months. We believe that the regulations and requirements of the program should look to other programs, to the best of the other programs, and pull those elements out. And we ought to have a streamlined and concise application process that the criteria will really encourage banks, existing banks and new banks, from participating.

And we would be happy -- and by we I mean the two organizations that I'm here speaking on behalf of today, IPAA and National Stripper Well Association -- to provide representatives to a working group, because I suspect that's what's going to be needed when you really begin to get into the details of this program to work with Commerce on the details of structuring a program that works for everybody.

That concludes my comments, and thank you very much.

MR. ORSZAG: Thank you.

Next up is Buzz Gralla, and he's the Executive Vice President of Bank One in Houston, Texas.

MR. GRALLA: Thank you very much. I appreciate the opportunity to be here today.

I am with Bank One, as was mentioned. I currently as responsible for Bank One's oil and gas producers as the clients of Bank One who are in the medium and small end of this business. I have been 35 years a commercial banker, and 22 years ago I made a decision to become an oil and gas banker, so I've been through a lot of the downturns, and, clearly, this last year has been -- last year, 18 months, has been the most severe that I've seen in my career.

Our organization, just as an example of a number of energy lenders around the country, we have been committing loans to this segment of the industry for over 50 years, and I'm pleased to say that we've never lost any money over that period of time to this industry. We've probably lost a little principal along the way but never lost any -- excuse me, a little interest but never any principal.

We also lend money to other industry segments, many of the service and supply and related manufacturing and equipment ends of the business, we also have commitments to. We have banks in all the oil producing regions -- Texas, Louisiana, in the Appalachian Basin, in Ohio, and in some of the northeastern areas outside of the Appalachian Basin, the Illinois Basin.

I thought it might be helpful to talk for just a couple of minutes about some of the basic elements of this business. I have some written testimony which will be submitted later that goes into probably some more detail, and it is probably more eloquent than my penciled notes.

This is truly a unique industry from a banker's perspective. I was trained as a general commercial banker, and then specialized in energy banking subsequently. It's unique from a couple of respects. It's unique -- and those at the Federal Reserve will appreciate this particularly -- that when you examine an oil and gas company's balance sheet and income statement, it looks a lot different than a manufacturing company or any other kind of company I've ever seen. The fact that a company's historical information either might be very bad or very good, very positive or very negative, really has no bearing on the soundness of the loan. It is really the projections that really count and the assumptions that go into those projections for the future; very unique to oil and gas banking.

Balance sheet assets was discussed earlier by Mr. Murphy that talk about accounting methods and present worth calculations of reserves and so on and so forth. Balance sheets of oil and gas companies make -- really don't portray the proper value of oil and gas. What does portray the proper value is an engineering report that goes with the company's financials, generally. Because of accounting methods, the assets are going to be either terribly overstated or very much understated, and it just depends on the assumptions that are being used; very unique also.

And then last but not least, it's a very difficult industry to understand in that it is an industry that has depleting assets to further complicate matters.

Another unique facet is that the assumptions that are used by the banks upon which to based a safe loan change very dramatically during certain periods, and I think the last 18 months is a perfect example of that. Hopefully we have some more energy up there.

It is also unique in that it's highly technical from a banking standpoint. We, for example, have ten petroleum engineers on our staff who do the bank's engineering to make sure that -- do review consultants' reports or company provided information to make sure that the assumptions that were used are consistent with the bank's assumptions are.

We talked about -- we heard some discussion by Mr. Murphy about reserve categories. One, in order to understand this business, must understand obviously the reserve categories, the consultants that we use, and our own engineers must make whatever adjustments they think are appropriate to tailor a safe loan.

Not unique, really, is that we establish a borrowing base, traditionally, for a company -- in making a loan to a company. But what is unique is it's based on future net revenues. Again, it's not based on the past; it's not based on what we see at a snapshot on the balance; it is based on future net revenues as determined by a third party engineering report, generally, or a company's information, which is then scrutinized by a bank engineer. We use our own oil and gas pricing assumptions. Then we apply a discount rate, which I believe Mr. Murphy talked about earlier. We happen to use eight percent. We think that's a realistic -- from the bank's standpoint, that's a reflection of, really, long-term rates, and that's how we size our loans.

Cash flow is the primary repayment source of an oil and gas loan. Asset sales sometimes can supplement the cash flow, but cash flow is king, so to speak, in this business, as it is in most businesses.

Somewhat unique is that we also have a six-month review of an oil and gas company's loan. We make a term loan; we make a revolving credit; we make a reducing revolving credit, combination of the two, but it is always subject to a -- generally, with a small or medium size independent -- a six-month borrowing base review, which is part of the reason I think that we have, and most oil and gas banks have, been successful in making safe loans in that we are able to adjust to changing environments as we change assumptions and make whatever adjustments in the loan amount or the terms of the loan or whatever might be required.

Oil and gas companies, because they have depleting assets, in order to live, must add to those assets or they will be out of business. And, so we take into consideration during our six-month update, our six-month review, what properties might have been added to the borrowing base and make those adjustments upward, and in some cases it goes the other direction.

And over the last year and a half, it clearly has gone in the other direction for most oil and gas companies in this sector, because they have not had the capital expenditure money or the cash flow to provide cap ex or the borrowing base to replace their reserves.

Some comments and recommendations for the program. First of all, there's no question that the need is real, notwithstanding the recent run-up in prices that we've seen over the last two or three months, the 1980's oil price -- and that continued, as well all know, into the first four or five months of this year, even at a lower level -- but 1998's price was $14.36 average, and in the first few months of this year, even lower. That has wreaked havoc on oil companies' balance sheets, severely strained working capital for the producers as well as manufacturing and service supply companies.

There have been a number of bankruptcies; there have been a number of restructures to date, and then on the banking side, there are many bank lenders -- not ourselves -- but many banks who have been providers of capital and some non-banks who no longer are funding a significant part of this particular industry. They have either up-tiered going for a safer haven, you might say, or just decided it's just not worth the effort to figure out how to make a good loan to many of these companies. So, the sources that these companies have -- the smaller independent and the smaller producer of services and equipment -- they have fewer financial institutions to turn to.

Those who are in this business today are using very conservative pricing assumptions in their underwriting process, and the regulatory authorities that regulate us I'm sure would want us to use conservative assumptions given the backdrop to what this industry has gone through, what we've seen in price over the last 18 months or so.

And the net result of that is that, as I think I mentioned earlier, the borrowing base, as calculated with lower assumptions, becomes smaller, which compounds the problem and reduces availability to the industry.

The recent run-up in price has to come too late for many of the producers, and so you find a number of companies who have been capital starved, many whose reserves have dwindled, because they haven't had the capital expenditures to reinvest in the business.

I don't pretend to have knowledge of -- enough knowledge of the other programs and this particular program, as envisioned, to give very specific ratio-type recommendations, but I do have some general recommendations that I'd like to provide.

First of all, I think that in tailoring this Government Guarantee Program to this industry, recognize its uniqueness. Secondly, fashion it broadly enough but also target it and focus to provide real assistance to those who really have the need. Develop a streamlined application and approval process for both borrowers and lenders to keep administrative costs to a minimum. And, frankly, if you don't do that, banks are not going to want to participate, and producers are going to say, "Hey, it's not worth my time."

Allow the concept of a qualified lender, which I believe is an SBA term, to allow banking institutions that are qualified to make oil and gas loans, allow them to deliver this product to the producer or the manufacturing company or service and supply company as opposed to having an application submitted to a Government agency. I believe that that is what is envisioned in any case, but I think if went a different direction, it would be very difficult for the machinery to operate.

I would also suggest that several loan products tailor to the needs and peculiarities of the several industry segments that we're talking about -- oil and gas producers, services by manufacturing companies -- be considered.

They might include loans for workover expenses that require very little capital expenditure but can produce some very significant increases in revenues and cash flow. To make development loans for proved undeveloped reserves with relatively low risk can take place but potentially above what a commercial bank might do in a non-guaranteed way. Acquisition loans -- there might be some prudent acquisitions that allow a producer who might otherwise not be able to survive to grow through economies of scale to reducing on a combined basis overhead, et cetera. And then, last but not least, there could be some project loans that might make sense.

Now, I'm also not suggesting in any way, shape, or form should -- this Program, in my opinion, should not be a bailout for the poorly managed company or for a bank lender or other lender's loan portfolio, and I don't believe that's what has been designed here, and I don't think that would be desirable. There have been some companies that are no longer on this Earth that probably never deserved to be here in the first place.

I think a priority list, a set of criteria, ought to be developed based on need of those who might qualify for this Program. I also think that time and speed of implementation is of the essence.

I would also recommend that a small team, call it an advisory group, to include experienced oil and gas bankers as well as a few industry representatives, be called upon to assist to critique the program. I know there are many of us, including myself, that would be very pleased to assist.

Some other more specific recommendations, which require some careful analysis, would be in the area of credit policy basics -- what the advance rate should be under the Guarantee Program, what the -- how to size the loan, what the amortization ought to be, how the pricing ought to be structured, will this Program apply across the board to public as well privately held concerns, and whether there should be separate loans or loans in combination with a traditional bank loan.

That concludes my remarks. I appreciate very much the opportunity to speak to you all today. Thank you.

MR. ORSZAG: Thank you very much.

Next up is Peter Noonan.

MR. NOONAN: Good afternoon, everybody.

I'm Peter Noonan. I'm a consultant that represents several small oil and gas operating companies, and they have asked me to come here to inject some of my thoughts and their thoughts in a concise manner. I hope that we can be beneficial to you all to make these decisions properly, and simultaneously we hope that we see some help, and that's what we're here for; we need help.

The last 18 months has not been a travesty, it's been a total disaster. I've driven out there in west Texas now for the last 18 months, and I can count how many wells we're producing on my hand. I can count how many rigs we're producing on my hand. I can count how many people's businesses are closed on my hand, because you can just keep counting and counting and counting, and they're just numerous.

And you see the schools are in travesty problems, because they don't have any taxes now, because there's no revenue. So, they're trying to figure out how to support teachers; they're trying to figure out how to support families. Most of them are on some kind of assistance of any kind.

Now, that's a travesty in this country, and so I'm going to try to give you an insight on what I think needs to be done and a pattern that maybe both of us can all agree upon.

We need to define what a small oil and gas operating company is. In the communique by the House bill itself it didn't define it; it just says small oil and gas. And then it was transferred to the Department of Commerce's web page. All of sudden, the "small" just dropped off the page, and it classified an Alaskan corporation as the definition of a small service company, but it didn't go any further. So, I think it needs to be defined.

There's a lot of small companies that have five, six, eight, ten people that have very little reserves, but they have 60 or 70 wells out there, and some of them are only producing two or three or four barrels a day. They have their own equipment; they survive on their own ingenuity , their own ability to just, pardon the expression, plow the field, even under the worst storms or even under hale or whatever tornadoes might come through the area. But they are producing cash flow. They don't have really reserve reports; they have cash flow.

And when it went down to $8, $9 a barrel, it wiped out the necessity values that they had to be able to function as a company. It went so deep this time that there is no reserve. And being that there's no reserve, how do they fall back? You go to Bank One, and the distinguished colleague addressed very well.

They don't talk to some companies, because they know they're not going to survive, because they're bankers. They're there to make sure they have good loans. They're protecting the investment of their banks. But who takes care of the people that all of sudden lost their jobs? Nobody's asking for a handout; they just want a fair deal.

The fair deal that they're receiving right now is controlled pricing from out of our borders. They dictate how much oil will be produced in this world. So, in other words, how do we control that? How does this loan situation kind of offset that to give them the struggle times from market or what they call a free economy or free enterprise system?

We don't have a free enterprise system in oil and gas. The pricing is controlled by the heavy marketers, which is the big oil companies, and the international cartels. And, so where are we at? The little guy out there is fighting not only his own Government but also every other government in the country and the world, because he's got state regulations; he's got environmental regulations; he's got taxation regulations; he's got everything that's piled on top of him, and he still has to function as an independent businessman, but simultaneously he has to be an oil and gas operator.

He's got to make hard decisions in an environment that's probably unspeakable to anybody in this room. Out there in 123 degree temperatures during the summer, early fall, and late spring, fighting it everyday, and then turn around and be out there in minus ten, minus 20 every winter. And nobody's sitting there asking for a handout. What they're asking is a fair deal.

So, maybe this Program might give them a chance to get some hearing out. Maybe this Program will be able -- be a defined situation. So, one of things we need to define is what is a small oil and gas company. I think that needs to be decided upon through cash flow. Is it $10 million a year or $2 million a year or $3 million a year? But that needs to be designed.

And then the debt structure needs to be designed with that in mind. Is it going to sustain itself for ten years, if it's going to be a ten-year loan or a five-year loan? That has to be addressed or contributed to that point.

So, years ago, before all our Texas banks went deep South on everybody -- not to the cause of their problems; they just didn't know how to handle themselves with this big boom of oil and gas, and there was a lot of bad situations there -- most of the banks gave production payment loans. They coordinated all of their product from those oil and gas operators, and they took so much of the value of those monies back from them. And sometimes it ran ten percent of their income, sometimes 12 percent, 20 percent, dependent on how they felt what they concise relationships were.

FDIC back in 1984, '85, said, "This is the end of that." I was caught in one of those things. I understand how it happened, and it was a bad situation. The bankers didn't know what to do. They said they can't do it anymore, but they already had structured deals that they were supposed to by contract. They didn't live up to their contract. Most of the small independents didn't have a chance to go fight for it, take it to court. They didn't have the money. That's always the key is money.

So, somewhere there has to be some kind of relationship of the price of oil, the value of money, and, too, the cash flow of the concerned. And they want to pay back their loans, because nobody walks away with a bad debt in this country. It's a small world, and it will catch up to you, so that's why everybody might owe a lot of debt out there, but they're going to pay it somewhere up the line. I haven't seen many people default on it; they just keep trying and trying and trying until they can get there. So, that's one thing that needs to be addressed.

We have a situation at this point that we have pessimism. We've gone through Murphy's Law, which was supposedly the view of the pessimist, but then Schwartz who definitely became Murphy's optimist, and now Schwartz is the pessimist. But we've gone one step further; we went to despair. There is no hope in a lot of those people out there. They're just working towards an end. They don't know what that end is, so they can't see it.

And stripper production is anything under ten barrels a day, that's 47 percent of all production in this country right now -- 47 percent. We're not talking about imported oil or anything like this, because that's how much is out there. So, we're on a weaning down position, but we have lots of reserves, lot of reserves. They haven't been able to get it out of the ground, so there's no technology that has created a way for that to happen. Everybody's been waiting to see it. They're looking for the God gift from the Heavens above to find out if it happened, but they haven't seen it yet. So, there has been no technology innovations to smaller operators. They don't have a source of it. They don't see any basis of it.

And one of things that one of the banks

-- Buzz has said that there needs to be some input. There needs to be some new thought on projects. Of course he put that on the last of his totem pole. Everything else was above, but if we're going to sustain our security in this country and maintain our position -- those ships out there run on kerosene now. We've got jet engines in it. We run high up to the aircraft, which has that oxidated gasoline and kerosene. These are all things that are necessary for this country to provide a good, solid defense.

But we're working towards that. The small independent producer is the backbone of this country. When he runs -- he's the horse; the cart is all behind. The steel industry -- that's right, why is the steel industry behind the producer? Because he buys tubulars; he buys plate; he buys a lot of things to make his field work. Pump jacks -- these are all part of the system, but he buys it all, and everybody behind there has to ride that cart.

So, in other words, now the producer is the front runner. So, do we give all the money to the manufacturers or to the small operators? If the small operators have it, will spend the money; they always have. They have work orders. I'll give you an example.

About eight, ten weeks ago, this company lost its saltwater disposal injection well. Their entire field was put in total jeopardy. They couldn't get a temporary permit because of the bureaucratic problems developing with the filings and things of this nature. It takes about eight or nine, ten weeks. They couldn't produce those wells properly. There were at 200 and plus barrels a day, and all of a sudden they were at zero. So, they had to go back and restart.

Well, restarting means that they had to go back to a complete workover of every well, because the wells sanded up, paraffined up. So, in other words, some of those wells didn't really come back. Right now, they're at 158 barrels. So, in other words, they went from 200 plus down to 158 only because of a problem that was addressed only because they could produce saltwater out of that well, but they couldn't inject the same saltwater back in that well, because it was all right to produce it but not right to inject it, because they want to protect fresh water. They do that every time they drill a well. They protect it, but then the bureaucrats need to come through the system and establish what is really good for the public? Are we doing it already? Let's don't make it complicated. So, they have to change to the wheel.

So, this is what happens when we go to a Loan Guarantee Program. We've got to make it simple. We've got to make it as quickly as possible to help people. We've got to have the lenders in conjunction with the oil and gas operators that they're working hand-in-hand. They can have engineers on their staff and give them all the parameters that they have, but if those engineers have never worked in the field, they don't understand those parameters.

Yes, there's a lot of engineers out there who have certificates, but they never really actually had on-the-job training, and they don't really understand the inner workings of those systems. So, in other words, if a lending institution has to rely on the engineers to make a decisive situation, they need to have people who are trained to understand what those are or get in the field with their people.

I remember banks used to have a consultant or a lender -- the guy that usually said okay about the loan -- he'd come by and sit down with that individual every other week and say, "How are you doing? Tell me some of your problems." They were understanding the guy's business, because they were trying to figure out if he was really going to be successful or not.

They don't do that anymore. They look at it in six months, and the next minute they're going to say, "I'm going to call your loan." And the guy's hurrying around trying to figure out he's going to sustain himself.

We need to put a relationship in there that the banker and the oil and gas operator, under these conditions, are working hand-in-hand, because it is a hand-in-hand deal. The banker used to be the person who supported that man, and the other guy was the man who made sure that all of the interest and fees were paid so everybody made a profit. So, that needs to be put back into the Program.

Furthermore, we need to address if it's a public or a privately-owned company. Public companies have a source of capital, and those sources of capital are far wide, because everything's above board. It's fully audited, things of this nature. Private is backed to having support of audits and things of this nature.

Usually a good audit will cost a man maybe $8 or $9 or $10,000 just for him coming and putting his John Henry on it, on a CPA. But sometimes you don't have $10,000. You'd rather put $10,000 in a workover well, so you get 12 barrels a day out of it, which will generate the same amount of money in one month at the present rate. So, that's where he likes to see his money spent.

I say we need to have independent audits, but it needs to be in a response time. In other words, can we include it in the fees that they be charged off to? Or can it be put into a situation that it's worked out of an in-house CPA and he signs off, because he's a CPA. Not an in-house account; it needs to be somebody who's certified.

The size and ownership of a company is very important. A lot of operating companies only own maybe 20 or 30 percent of their net wells. They might operate 500 wells, but they only own maybe ten percent of that -- 50 of them. But the other 90 percent is owned by investors. A lot of those investors don't stay in the system. When prices get bad, they don't pay their bills, and debt ratios start going out of sight. There has to be some way that the investor has to be tied into the Program, and they have to commit their funds the same way that the operator has to commit theirs. That's important.

Now, one of things that's been stated, the lenders themselves and the regional and the small banks basically are disenchanted with the oil and gas because of the cycle relationships of the price of oil. They don't want to be a part of that. They don't want FDIC on their back. They're trying to keep their debt equity relationships as high as possible, and they worry about those loans more than anybody. And the smaller banks who are basically in the smaller towns, like Roswell or Pegas or Hobbs or Carlsbad, they won't even talk to an oil and gas man at this point, because they're scared. They're scared of the cycle relationship of the pricing.

So, one of the remedies I would feel that might be workable is that maybe we can bring a consolidation of small banks together that they can act as one, but then one person carries the ball, to give them the right to do that, because their debt equity ratios are not high enough for some of the loans that would be necessary for some of these smaller operators, if they're going to be successful in bringing their operation back to what I call a good cash flow relationship.

The effect of oil, gas operating company on an economy generates ten service jobs for every person they have working for them. That's right. So, in other words, how do you say that? Well, if you go back through the recirculation of dollars, you'll find that that money's flowing ten times, and that is one industry that does buy. They use their capital, and they use it to expend it, and they use it every day. They don't sit there and hoard it, because they don't have enough money to hoard at this point. So, in other words, they're sitting back, and it's putting those people to work.

If we take, for instance, what's happened since 1983 when there was a downturn of really the oil and gas and everything to that point, there's been 500,000 jobs lost. That's beyond any thoughts. If we add the other five million service jobs related, that makes it even worse; just a travesty. We haven't addressed that. I think we need to get them back to work, and this is one way we can do this.

We've got to bring these people together.

We've got to get this spare out of their system. So, we need to get the lenders to act on their behalf in conjunction, and let them work with the small oil and gas concerns. You'll find that they'll spend the manufacturing, the service companies, such as the well workovers, the supply stores, when that money is starting to flow, it is spent to everybody. That's right. And they spend it every day.

Last month, this one company spent $12,000. That was 20 percent of that total oil company's sales for the month -- 20 percent. When that store used to do almost only one percent, and that's how bad it's become.

So, when they asked me to come talk to you all, they were talking on their behalf as well. They say get the people to work by putting the wells back on, and he says, we will work right behind, because we'll be able to put those valves, fittings, chokes, things of this nature, pump jacks, electric motors, electric, everything on down together, and it works.

MR. ORSZAG: Mr. Noonan, can I ask you to wrap it up, please, because we're just trying to keep everyone to ten minutes.

MR. NOONAN: Yes, I'm ready to go.

Okay, in conclusion, we need to be able to make sure that if there is an audit, let's do an audit on an annual basis, not at the beginning, because a lot of these people, they have in-house financials but that's it. We need to know how the use of the proceeds should be. Should they be in the restructuring of debt or a combination thereof for new production? And application of fees, we need to know is how to associate it with other programs. Are they set up to a half percent? Well, we've got to see those fees are addressed. And then the reporting requirements, that needs to be addressed as well. And then we need to make sure that ties to financial institutions to make a ten-year loan or a seven-year loan, will there be a provision of some interest factor that can grow, like set to prime or something of this nature, so they don't get locked in?

In conjunction, I appreciate your time. Thank you for all your concern for everything, and thank you for passing the bill. I know you had nothing to do with it, but I know you were supporting it, and I appreciate it very much.

Thank you.

MR. ORSZAG: Thank you.

Next up is Bryan Bently.

MR. BENTLY: I wish to thank the Board for permitting my comments this afternoon.

I am President of Starlight Corporation, a small non-public, independent oil and gas producer in Colorado. Starlight is a young company -- only four years old. We own and operate approximately 100 oil and gas wells north of Denver, employ six people directly, and produce about 250 barrels of oil equivalent per day. We help support a score of smaller oil and gas service companies in the area.

Today, I will offer our perspectives in two areas that we believe are relevant to the Board. First, I will briefly describe the difficulties faced by small independents in obtaining financing for quality development projects. My comments will focus upon small independents only as large independents have ready access to capital much as do the major integrated oil and gas companies. Second, I will offer several specific recommendations regarding the regulations that you are preparing.

As you know, an independent like any firm may finance projects from public or venture equity, public or private debt, or internal cash flow. For a small, private independent, public, equity, and debt markets are effectively closed. Venture capital, venture equity, where it exists, is limited to a narrow range of especially lucrative projects. Internal cash flow alone cannot sustain the development spending, which an independent must execute if it is to survive, grow, and prosper.

Project funding is effectively limited to secured energy loans from commercial banks and mezzanine debt provided by specialized investment banks and energy trading companies. In both cases, debt capital is rationed away from the small independent.

With commercial banks, small independents face several dilemmas. First, commercial banks will generally lend against proved producing reserves only, those which are flowing and generating current cash flow.

Second, commercial banks cannot or prefer not to fund development drilling projects, which is the independent's principal path to grow and which put new oil and gas reserves in the nation's domestic inventory.

Third, loan sizing criteria, such as advance rates, future oil and gas pricing projections, and amortization schedules, tend to be tightly drawn especially after the experience of the last few years.

Fourth, many independents have no capacity in their existing secured loan facilities, because they are in mandatory paydown due to conservative price projections or are at facility size limits after surviving the last few years.

And, finally, ongoing commercial bank consolidations have results in fewer experienced bank energy groups having either the resources or the interest to devote to the needs of the small oil and gas companies.

As an aside, the Emergency Oil and Gas Guarantee Loan Program is not necessarily targeted to assist smaller, local commercial banks. However, the Program reduces the uncertainties perceived in financing development drilling as opposed to the greater certainty of loaning against only existing production. Thus, the Program may encourage these banks to become educated and comfortable with funding quality development projects in their own communities, many of which still suffer from depressed energy investment.

Let me next briefly address mezzanine debt whose providers take small equity position in projects as part of their overall return. Providers of mezzanine debt do regularly fund development drilling projects, as their profit can be significant. However, the minimum deal threshold for these firms is roughly $10 million. This is because such firms, frequently located in Houston near the Gulf, now have abundant projects in the 20 plus million dollar range for which to compete. It takes nearly as much due diligence effort for their limited staff to process a $3 million project as a $20 million project, and the latter are vastly more profitable for the time spent.

The few providers that of mezzanine financing that did exist in the low end of the market, realizing that they were essentially alone, charged effective interest rates of 20 to 40 percent per annum, among non-competitive terms. And with the recent explosion in gas and oil prices, they too have move up-market.

For these reasons, I believe that the Emergency Oil and Gas Guarantee Loan Program, if properly structured, will induce commercial banks and providers of mezzanine debt to work with small independents like ourselves to fund quality projects and add oil and gas reserves to the nation's inventory.

I will devote the balance of my time to offer a few brief points regarding the structure of the Program. First, the program should be explicitly targeted toward development drilling and exploitation of proved and probably reserves, including the installation and upgrade of directly associated producing infrastructure, such as local gas gathering systems. The Program should not be used to fund acquisitions, as this activity simply moves money around the oil patch and artificially raises prices without adding reserves to the nation's inventory. It should not be used to fund downstream activities such as gas processing plants for which there is already adequate capital. Likewise, the Program should not be used to fund exploration, which is a high-risk activity which is best funded with venture equity from within or outside the firm and not with debt.

Second, the designation of project reserves as proved or probable must be endorsed by a certified and recognized independent petroleum engineering consulting firm. This is a standard requirement for the financing of oil and gas projects, and ensures that the project is quality, viable and economic, and will generate sufficient cash flows to repay the guaranteed debt as scheduled.

Third, the Board should look to the financed project alone, not the entire company's assets, for the principal collateral that it requires to support the loan guarantee. If the project is certifiably economic, it should generate sufficient cash flows to service its own debt. The Board should, if it desires, take a second mortgage over the company's remaining assets behind the independent's principal lender. This is important. A small independent's existing lender frequently has a first mortgage lien upon all of the company's tangible producing assets. In addition, the lender is probably holding personal loan guarantees from the company's principals themselves. At high current prices, there should be some additional debt capacity available to the independent from his principal lender through existing secured credit lines. Coupled with 85 percent guaranteed debt, which is secured by the developmental drilling project, this additional debt capacity can yield the remaining 15 percent to permit the project to go forward, while the principal lender remains adequately secure. If, however, the Board requires a first mortgage over much or all of the company's tangible assets as a price of the guarantee, then it may be difficult for the small independent with quality projects to participate in the Program at all.

Fourth, the Board should give guarantee preference to those independents that actively engage in the practice of hedging their oil and natural gas sales prices at least one year into the future. In fact, the Board should require that some portion of the guaranteed project's cash flow -- at least enough to service the early years of the guaranteed debt -- be hedged. This recommendation recognizes that much of the risk adherent to repaying oil and gas refinancing is tied directly to the uncertainty of future oil and gas prices.

Fifth, the Board should apply the $10 million guarantee limit to individual oil and gas development projects themselves, not merely to the company. This will ensure that much larger, readily capitalized projects are not funded through consortia of qualifying companies, which will deplete much of the Program's authorized aggregate limit of $500 million.

Finally, I would suggest that the requirement for a General Accounting Office audit be performed by local certified public accounting firms employing GAO rules and guidelines.

Thank you again the for the opportunity to speak regarding this important program.

MR. ORSZAG: Thank you very much.

That's the last of the scheduled speakers. I don't know if there's anyone else who came here today thinking that they were going to speak and wasn't on the schedule. If there's not, I want to thank everyone for coming. We truly appreciate the input that we received, both this morning on the Steel Program and also this afternoon. We have a large challenge in front of us to finish these regulations and to get them out the door in 28 days, which is what the legislation dictated.

So, I want to thank you, and I want to know if Susan wants to make any comments too?

MS. WYDERKO: I just wanted to express my thanks to everyone who came here and everyone who testified. It's been very illuminating, and it's given us all a lot to think about as we go forward and try and figure out how to administer this loan -- this Program in the way that will bring the most good to the most people and bring needed help to the oil and gas industry.

Thanks very much.

MR. ORSZAG: Thank you.

(Whereupon, the above-entitled public meeting of the Emergency Oil and Gas Guarantee Loan Board was concluded at 2:39 p.m.)